



Western
Independent
Bankers

Directors Digest

A Community Bank Directors Advisor

Issue #21 – March 2009

Current Regulatory Hot Spots

By Kevin Watson, AuditOne LLC

Serving as independent outsourced internal auditors to nearly 150 banks in the western United States and elsewhere, we at AuditOne are privy to many regulatory examination reports. This wide and deep industry view gives us a solid sense of what regulators are concerned about, what they're currently focusing on, and what issues are attracting attention.

While Part 309 of the FDIC Rules & Regulations prohibits disclosure of examination reports, we feel it is healthy for the banking industry to receive timely information on the nature of issues being cited in those reports. Following are some of the deficiencies and topics of scrutiny appearing frequently in recent examination reports. (As you would expect, many of them relate to credit and liquidity. Capital is often times mentioned too, but with capital you either have enough or you don't.)

Recent Regulatory Hot Spots:

Allowance for Loan and Lease Losses (ALLL) – failure to make use of historical charge-off factors adjusted for qualitative factors as required by the Interagency Guidelines issued in December 2006.

CRE Concentration Risk Management – failure to follow the risk management practices of the CRE Interagency Guidelines issued in December 2006. For banks with commercial real estate concentrations, additional risk management procedures over real estate loans are required concerning board and management oversight, portfolio management, management information systems, market analysis, credit underwriting standards, portfolio stress testing and sensitivity analysis and also the credit review function.

Credit Reviews – inadequate frequency of credit reviews. Small community banks are being asked in many cases to increase to semi-annual frequencies. Larger banks are increasing to quarterly or even bi-monthly reviews.

Credit Stress Test – failure to perform credit stress tests, especially for commercial real estate lenders. Sensitivity analysis should be performed on loan portfolios at a minimum based on the impact of relevant debt coverage factors such as vacancy rates and interest rate resets. In addition, portfolios should be stressed for the impact of collateral valuation declines.

Liquidity – failure to document a liquidity contingency plan and present it to appropriate Board and management committees.

Flood insurance – we continue to see civil money penalties assessed for flood insurance violations. Perhaps this is because flood insurance is such a black or white issue. Flood certifications need to be run for all loans secured by real property, timely notices must be sent when properties are located in flood zones, and insurance must be force-placed on a timely basis if the borrower doesn't self purchase flood insurance.

Remote Deposit Capture – while we have not seen severe criticisms, we have heard of increased scrutiny in regard to policies and procedures, client training, account underwriting, and audit coverage. With the recently released regulatory guidelines, we expect scrutiny to increase even more in 2009.

Identity Theft – while we haven't received reports of scrutiny, we believe that is because the regulation only became effective November 1. Most likely, the next round of examinations will apply attention to the area. We think you should be in good shape as long as you have a Board-approved policy and have provided training to employees.

California Division 1.6 – we've heard reports that the California DFI is expecting to see policies in place in regard to predatory lending, even if a bank is not in the subprime business.

On the horizon, common sense would tell us that usage of TARP funds will become the subject of examination scrutiny. In this environment, expect elements such as executive compensation and perks to be scrutinized even at banks not receiving the funds.

Kevin K. Watson is CEO of AuditOne, LLC (www.audit-one.com), a California-based independent internal audit firm specializing in banks and their service providers throughout the United States. Watson has 22 years of experience in the banking and auditing industries. He can be reached in AuditOne's Southern California office at 562-802-3581 or kevin.watson@audit-one.com.